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"*Nothing concentrates the mind like the prospect of being hanged in the morning*."

— Samuel Johnson, 18th century English writer

Dear Friends,

Well, how's that for a maudlin way to start a client letter? We thought about sarcastically using the famous quote from Alfred E. Neuman of the late, great Mad Magazine (*What…me worry?*) but we used it to kick off a letter about five years ago. The fact is that we are quite worried about the speculative impulses of the markets: stocks, bonds and real estate, not to mention things we choose not to own such as cryptocurrencies, NFTs and tulip bulbs. *Especially* when coupled with the growing rate of inflation. Suffice it to say that of late our minds have become quite *concentrated*.

Irrational Exuberance Turns 25

Twenty-five years ago last month, then chair of the Federal Reserve Alan Greenspan uttered those famous two words in which he inferred that asset prices were reaching unsustainable levels. Greenspan was correct but for one not-so-small caveat. His timing, shall we generously say, sucked. It took nearly three more years before the Chair's prognosis came to pass and the bubble burst. His biographer, Sebastian Mallaby, observed "the more the cliché was repeated, the more the market seemed to soar." Stocks continued to trade up into what became known as the dot.com bubble which finally burst in early 2000. It is noteworthy that Greenspan later admitted that a.) His choice of words was intentionally provocative and b.) The concept came to him in the shower, a fine place for scrubbing up concepts. Greenspan later confessed it absolutely was his objective to call out the markets (stocks, bonds *and* real estate) on the bubbles he foresaw forming. In so doing, it was his hope to mitigate the damage.

To the extent that Chair Greenspan was directionally correct, what might he have to say about today's asset prices and the underpinnings to them? Please allow us to speculate. We fully expect his counsel would be much the same as in late 1996 as the parallels with today are uncanny. Low interest rates eventually leading to much higher rates will likely serve to slam the brakes on the economy. Especially where borrowed money is involved, damage may be severe as a result. Booming residential real estate immediately comes to mind as higher mortgage balances and interest rates depress purchasers' ability to afford ever more expensive homes. Longer term bonds are similarly exposed. The Wall Street Journal's weekly publication, Barrons, this week pointed out that the 30-year Treasury bond now yielding just 1.9% would drop *20%* in price if interest rates were to rise just one percentage point. In some high flying industries, stocks have already begun to retreat in price but still have a considerable way to go before they can be said to have normalized. The freakish mix of gimmicks such as SPACs (aka Special Purpose Acquisition Companies) and meme stocks (emergent companies trading at sky-high valuations to their often non-existent earnings) and the wild purchases of short-term stock options by newly minted day traders would certainly earn a thumbs down warning sign from Mr. Greenspan.

Where does this leave us? Cautious. Very cautious. We began doing some de-risking last year. Some of that came as a result of a takeover, others from outright sales. We remain "open for business" as always to the extent that we can find companies trading at reasonable valuations to earnings and growth. Banks remain attractive as they actually benefit from rising interest rates. Financial institutions also find themselves to be

substantially over reserved in relation to potential loan losses unlike the catastrophe that was 2008-2009. This also bodes well for significant increases in dividends and share buybacks. German car company Porsche/VW is interesting at a valuation of roughly eight times estimated earnings and is well into rolling out electric autos en masse not far down the *road* (good pun, eh?).

Inflation…the Good, the Bad and the Ugly

The Good: Weird science this inflation business. If you own a high quality piece of real estate with a history of low vacancies which quickly re-rents to good tenants, inflation generates a wry smile. Most of your monthly expenses do not increase thanks to a fixed rate mortgage but your income from higher rents does. Once in a while interest rates fall and you may have an opportunity to refinance at a lower rate. Let's see…income up and expenses down. Nice equation this.

The Bad: Who then is afraid of inflation? Renters. Consumers. Those with credit card debt and variable rate loans. You and me in our everyday lives as the cost of goods and services outstrips the growth in our incomes. In other words, the stuff that generates depressing stories on the evening news. It is our view there is a significant possibility that the Federal Reserve may have overplayed its hand in keeping interest rates too low for too long. Really cheap money certainly encourages demand and stresses supply.
The Ugly: Then there is the other side of the coin: cost-push inflation for businesses and their owners/shareholders. Raw materials and labor costs up but with little opportunity to raise prices thanks to much competition, especially from overseas where wages are lower. Jobs are lost. Congress passes a bill raising tax rates on corporations to help cover the government's growing expenses and the bank notifies you the interest rate on your loans is going up. Demand softens as your customers are squeezed and competitors start liquidating their inventories to raise cash. Your proverbial vicious circle.

Strategic Implications and Opportunities for You

Given the prospect of being metaphorically hung in the morning if we fail to get this moment right has certainly served to help concentrate the mind. What kind of asset allocation (the mix of stocks, bonds and money market funds) now makes the most sense? Are there industries that may actually benefit by the fundamental changes beginning to appear in the economy such as higher interest rates and inflation? If so, are we, meaning you, so invested? Some short answers:

- A significant majority of the stocks you hold carry valuations to earnings well below those of the broad market. Lower expectations are preferred to stratospheric ones when risks are elevated.
- We are increasing the sale (writing) of call options as a minor hedge after being somewhat dormant in recent months.
- One of our greatest areas of concentration is banks and insurance companies. These industries are uniquely positioned to benefit from rising interest rates and have been cautious lenders in recent years. Both trends are leading indicators of higher profitability. Dividends are well above most other industries. Recent outperformance of these groups has been notable. The incremental cash flow is very nice to have, especially in down markets.

- Select pharmaceutical stocks have been and continue to be in the spotlight due to COVID. We have benefited from owning them. Significant dividend increases have accentuated their attractiveness.

- European stocks have lagged badly in recent years. Bargains are less difficult to find in this space. Recently we began to purchase German car company Porsche (actually a mini-conglomerate consisting of both Porsche and a significant portion of VW in a holding company). The company is deeply into development of battery powered cars, has multiple assembly lines under construction and enjoys avenues for cost effectively funding this initiative which are not open to competitors.

Kudos to Sam!

It is with great pleasure that we share with you that our associate Sam Manafi now has a string of letters following his name…CFA. Sam has spent much of what little spare time he has had over the past four years studying for the financial analyst's version of the bar exam to earn the designation as a Chartered Financial Analyst. According to Bloomberg Financial News, the passage rate for the easiest of the three exams in 2021 was 26%. Please join us in congratulating Sam.

A Marathon. Not a Sprint.

Very clearly we all still have miles to go before we complete this COVID marathon. Cruelly there are no mile post markers along the way. Not knowing is the worst. Even marathon runners get to know how far it is to the finish line. Maybe worst of all has been not being able to "run" together. We miss seeing you and having the time just to chat. It is our hope that these communications have helped to fill the void and are useful to you. Your numbers are better than we could have imagined had we known COVID was coming in February of 2020 and hope you feel the same way. Please do not hesitate to give us a call if you have any questions about your review or our commentary.

Think positive and test negative!

Best regards,

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